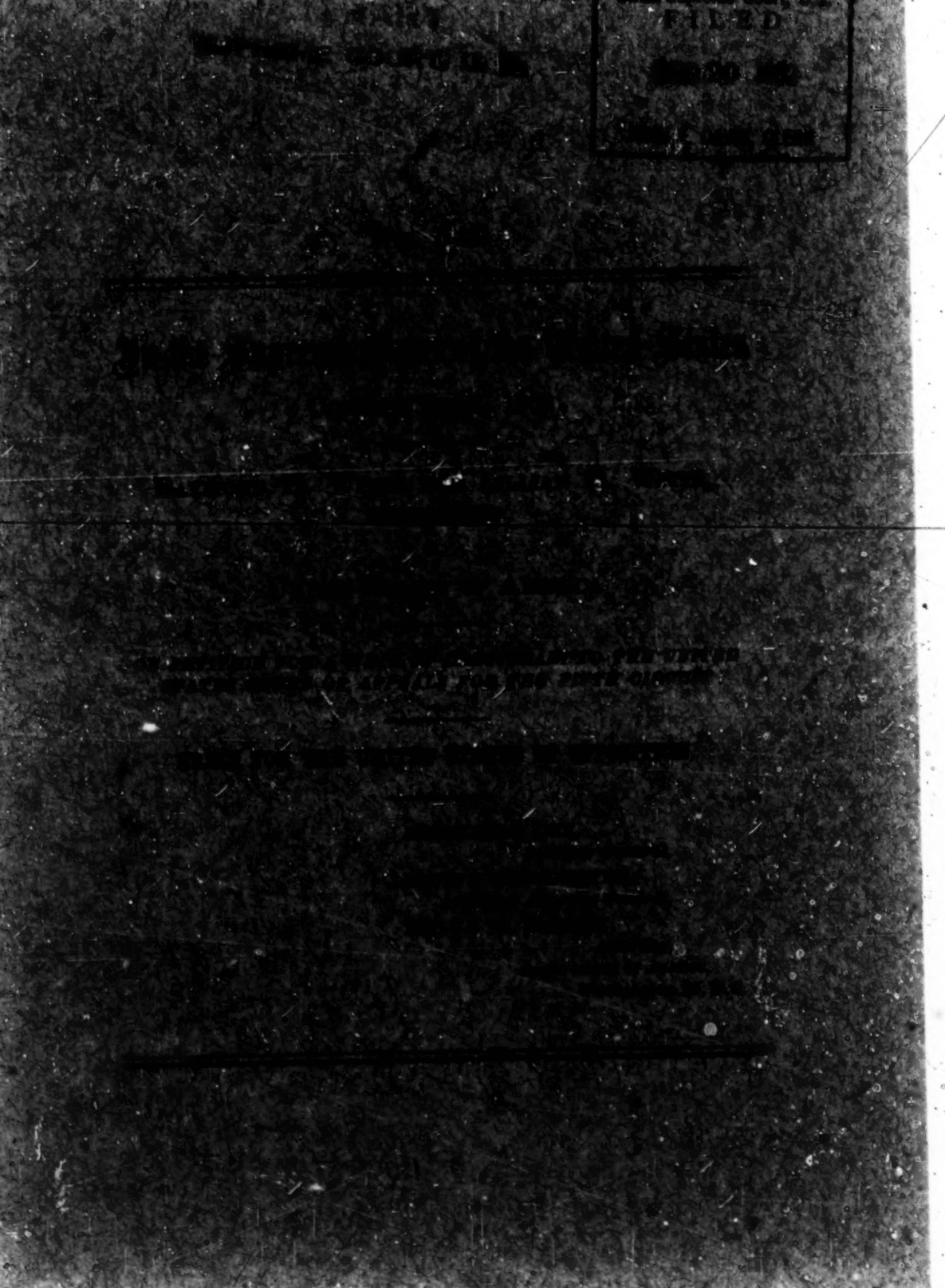

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statement	2
Argument	5
Conclusion	12

CITATIONS

Cases:	
Anderson v. *Helvering*, 310 U.S. 404	5
Barker v. *Commissioner*, 250 F. 2d 195	9, 10
Bell v. *Commissioner*, 219 F. 2d 442	8
Berry v. *United States*, 267 F. 2d 298	8
Burnet v. *Harmel*, 287 U.S. 103	5
Burton-Sutton Oil Co. v. *Commissioner*, 328 U.S. 25	5
Choate v. *Commissioner*, 141 F. 2d 641, reversed, 324 U.S. 1	7
Commissioner v. *Smith*, 173 F. 2d 470, certiorari denied, 338 U.S. 818	8
Commissioner v. *Southwest Expl. Co.*, 350 U.S. 308	5
Crowell Land & Min. Corp. v. *Commissioner*, 242 F. 2d 864	10
Doyle v. *Commissioner*, 102 F. 2d 86	8
First Nat. Bank of Mobile v. *Commissioner*, 183 F. 2d 172	8
Gowans v. *Commissioner*, 246 F. 2d 448	9–10
Haggard v. *Wood*, 298 F. 2d 24	8
Helvering v. *Smith*, 90 F. 2d 590	8

670041—62

Cases—Continued

	Page
Hogan v. *Commissioner*, 141 F. 2d 92, certiorari denied, 323 U.S. 710	7
Hulbert v. *Commissioner*, 227 F. 2d 399	8
Kirby Petroleum Co. v. *Commissioner*, 326 U.S. 599	5
Leff v. *Commissioner*, 235 F. 2d 439	8
Linehan v. *Commissioner*, 297 F. 2d 276	9, 11
Long v. *Commissioner*, 173 F. 2d 471, certiorari denied, 338 U.S. 818	8
Meyer v. *United States*, 213 F. 2d 278	8
Palmer v. *Bender*, 287 U.S. 551	5
Parsons v. *Smith*, 359 U.S. 215	5
Sherlock v. *Commissioner*, 294 F. 2d 863, certiorari denied, 369 U.S. 802	8
Swiren v. *Commissioner*, 183 F. 2d 656, certiorari denied, 340 U.S. 912	8
Thomas v. *Perkins*, 301 U.S. 655	5, 6
Trousdale v. *Commissioner*, 219 F. 2d 563	8
Tunnell v. *United States*, 259 F. 2d 916	8
United States v. *Donoho*, 275 F. 2d 489	8
United States v. *Shapiro*, 178 F. 2d 459	8
United States v. *Snow*, 223 F. 2d 103, certiorari denied, 350 U.S. 831	8
Watson v. *Commissioner*, 345 U.S. 544, rehearing denied, 345 U.S. 1003	7

In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 549

RAYMOND H. WITTE AND LILLIAN B. WITTE,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The findings of facts and opinion of the district court (R. 111–122) are reported at 201 F. Supp. 525. The opinion of the court of appeals (Pet. 1a–15a) is reported at 306 F. 2d 81.

JURISDICTION

The judgment of the court of appeals was entered on July 25, 1962. (Pet. 16a.) The petition for a writ of certiorari was filed on October 23, 1962. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether the court below erred in holding that the overriding royalty or production payment reserved by the Louisiana Sand and Gravel Company, a partnership, on the transfer of its assets to Witte Gravel Company was a retained economic interest in the sand and gravel in place, with the result that the income received therefrom during the taxable years is taxable to the partners, including this taxpayer, as ordinary income subject to depletion, rather than as capital gain.

STATEMENT

The taxpayer Raymond H. Witte[1] was a partner with two other parties in the Louisiana Sand and Gravel Company, which was in the business of producing and marketing sand, gravel, and related products in the vicinity of Kinder, Louisiana. Prior to January 1, 1953, the partners expressed an intent to sell the business, the assets of which consisted of equipment and interests in sand and gravel properties. (R. 111–112.)

By two separate instruments dated February 20, 1953, but effective January 1, 1953, the Witte Gravel Company, a Delaware corporation, acquired the assets of the Louisiana Sand and Gravel Company and all the related assets of the partners, except for cash, accounts receivable, and insignificant miscellaneous assets of nominal value. (R. 112–113.) One of these instruments was a Bill of Sale and Agreement (Ex.

[1] Raymond's wife is a party to this suit only because of the filing of joint returns. (R. 111.) We will therefore refer to the husband as the taxpayer.

1-A, R. 143-149) in which the taxpayer and his partners conveyed to Witte Gravel Company their machinery, equipment and supplies, and promised not to compete with Witte Gravel Company for fifteen years, all in return for a promissory note in the face amount of $578,550.53 (Ex. 2-B, R. 150-153), secured by a chattel mortgage (Ex. 3-C, R. 154-176). (R. 113.)

The second instrument was a "conveyance and agreement" providing that the taxpayer and his partners as assignors "do hereby GRANT, BARGAIN, SELL, TRANSFER, ASSIGN, SET OVER and DELIVER," to the Witte Gravel Company as assignee "the following instruments of lease and/or instruments of sale and conveyance * * *." (Ex. 4-D, R. 177, 179.) These consisted of five leases; two instruments described respectively as "Sale of Sand in Place" and "Sale of Sand and Gravel in Place"; and one instrument described simply as "Agreement dated October 2, 1952, between Mrs. J. O. Modisette, a widow et al., as Vendors, and Louisiana Sand & Gravel Company, a partnership, as Vendee", covering a certain eighty acres of land. (R. 179-181.) The instrument also provided, except as to one of the leases (R. 183-184), that—

> there is by Assignors excepted from this assignment and expressly reserved unto themselves * * * as a limited overriding royalty interest or production payment * * * an undivided fractional percentage of all sand and/or gravel, in, on or under and to be produced, saved and sold from the lands, or any part thereof, covered by the above-described instruments of lease and/or sale and conveyance

> * * * sufficient to yield, at the rates and in the manner hereinafter set forth, the full net sum of One Million Dollars ($1,000,000) * * *. Said limited overriding royalty or production payment shall be payable out of the proceeds of the sale of sand and/or gravel, and only out of same and not otherwise * * *.

The instrument provided that for the first four years payment was to be made at the rate of five cents per ton on the first 300,000 tons of sand and/or gravel produced, saved, and sold from the premises each year, plus ten cents per ton on the excess, until the partners had received a total of $750,000; and thereafter at the rate of two cents per ton until the partners had received the remaining $250,000. The agreement also expressly provided that the assignee, Witte Gravel Company (R. 185)—

> shall never be personally liable for the payment of the amount of the aforesaid limited overriding royalty interest or production payment, or any part thereof, and that Assignors, their heirs, representatives and assigns shall look exclusively to the sand and/or gravel herein reserved to them for the payment thereof and that Assignors, their heirs, representatives and assigns shall have no lien or other security whatsoever for the payment of said limited overriding royalty interest or production payment * * *.

The Commissioner allowed the taxpayer to treat the gain upon sale of the equipment as capital gain, but asserted that the limited overriding royalty or

production payment constituted ordinary income subject to depletion. (R. 12–20.)

The district court held that the entire transaction constituted the sale of a going partnership business for which the limited overriding royalty or production payment was a part of the purchase price and thus taxable as capital gain, rather than the proceeds from a retained economic interest in the sand and gravel in place, taxable as ordinary income subject to depletion. (R. 119–122.) The court of appeals reversed, holding that the limited overriding royalty or production payment represented the retention of an economic interest in the sand and gravel in place. (Pet. 1a–15a.)

ARGUMENT

The judgment below is correct and the conflicts in decision asserted by the taxpayer are non-existent. There is no occasion for review of the case by this Court.

1. The decision below is correct. A long line of cases in this Court[2] have established that a transaction involving the disposition of a natural resource will not be treated as a sale of the resource "in place" where the grantor must look for his payment solely to the extraction and sale of the resource by the grantee. In such cases, the grantor is said to retain an "economic interest" in the resource in

[2] *Burnet* v. *Harmel*, 287 U.S. 103; *Palmer* v. *Bender*, 287 U.S. 551; *Anderson* v. *Helvering*, 310 U.S. 404; *Thomas* v. *Perkins*, 301 U.S. 655; *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25; *Commissioner* v. *Southwest Expl. Co.* 350 U.S. 308; *Parsons* v. *Smith*, 359 U.S. 215.

place, and must report the proceeds from the transaction as ordinary income, subject to a depletion deduction. Here, taxpayer (and his partners) retained "a limited overriding royalty" or "production payment" in the sand and gravel properties—that is, an undivided fractional percentage of all the sand and gravel in, on or to be produced, saved and sold from the lands, sufficient to yield $1,000,000. This amount was to be payable, on the basis of a unit price per ton, solely out of the proceeds from the sale of the material by the transferee. (R. 183–184). The court below properly held that the retention of such an interest is the retention of an "economic interest" in the sand and gravel in place and that the proceeds from it are accordingly taxable as ordinary income subject to depletion. *Thomas* v. *Perkins,* 301 U.S. 655.

This result is not altered by the fact that the transaction also involved the conveyance of the partnership's equipment, and may therefore be viewed as the transfer of a "going business enterprise." (Pet. 4a.) For the partners expressly withheld from this transfer, and retained the economic ownership of, a portion of the minerals in place. And the proceeds whose tax status is in question here derive not from the elements of the partnership business which were sold, but rather from the property which was retained. Moreover, petitioner's contention (Pet. 12–16) that the sale of a "going business" should not be broken down into ordinary income and capital gain components, as though there had been separate sales of the underlying assets (cash, inventory, good will, etc.) is beside

the point. For even if this "entity" theory be accepted, it does not follow that an asset which is expressly *withheld* from the sale must be treated as though it were an integral part of it.

This case is substantially similar to *Hogan* v. *Commissioner*, 141 F. 2d 92 (C.A. 5th), certiorari denied, 323 U.S. 710, and *Choate* v. *Commissioner*, 141 F. 2d 641 (C.A. 10th), reversed on another ground, 324 U.S. 1, which involved the same transaction but different partners. The partners, operating under oil and gas leases, conveyed, in a single transaction, their entire interest in the leases, wells and equipment for a cash consideration, but reserved a royalty interest in the oil which might be produced. Both courts held that the proceeds from the retained royalty interest were taxable as ordinary income subject to depletion. In view of the differing results reached by the two courts in relation to the manner in which the partners were to recover the cost of the equipment—whether through depletion or deduction of its costs as on a sale—this Court granted certiorari in the *Choate* case and resolved the conflict by treating the transfer of equipment as a sale. The Court's *Choate* decision thus implicitly approves what the taxpayer in the present case refers to as the fragmentation of a single transaction. And compare *Watson* v. *Commissioner*, 345 U.S. 544, rehearing denied, 345 U.S. 1003.

2. The decision below is not in conflict with any of the numerous decisions cited by the taxpayer (Pet. 12–16) relating to the sale of a partnership interest. As the decisions show, the courts are agreed that the sale of a partnership interest constitutes the sale of a

capital asset,[3] the only area of disagreement being whether income already earned is a part of that capital asset.[4] But the present case obviously does not

[3] *Leff* v. *Commissioner*, 235 F. 2d 439 (C.A. 2d); *Tunnell* v. *United States*, 259 F. 2d 916 (C.A. 3d); *Commissioner* v. *Smith*, 173 F. 2d 470 (C.A. 5th), certiorari denied, 338 U.S. 818; *Long* v. *Commissioner*, 173 F. 2d 471 (C.A. 5th), certiorari denied, 338 U.S. 818; *First Nat. Bank of Mobile* v. *Commissioner*, 183 F. 2d 172 (C.A. 5th); *Sherlock* v. *Commissioner*, 294 F. 2d 863 (C.A. 5th), certiorari denied, 369 U.S. 802; *Berry* v. *United States*, 267 F. 2d 298 (C.A. 6th); *Swiren* v. *Commissioner*, 183 F. 2d 656 (C.A. 7th), certiorari denied, 340 U.S. 912; *Meyer* v. *United States*, 213 F. 2d 278 (C.A. 7th); *Hulbert* v. *Commissioner*, 227 F. 2d 399 (C.A. 7th); *United States* v. *Shapiro*, 178 F. 2d 459 (C.A. 8th); *United States* v. *Donoho*, 275 F. 2d 489 (C.A. 8th); *United States* v. *Snow*, 223 F. 2d 103 (C.A. 9th), certiorari denied, 350 U.S. 831.

[4] The Second, Third, Fifth and Ninth Circuits have held that on the sale of a partnership interest income already earned is taxable as ordinary income. See *Leff* v. *Commissioner*, *supra*; *Tunnell* v. *United States*, *supra*; *Sherlock* v. *Commissioner*, *supra*; *United States* v. *Snow*, *supra*; cf. *Helvering* v. *Smith*, 90 F. 2d 590 (C.A. 2d). The Seventh Circuit is apparently now in agreement. See *Hulbert* v. *Commissioner*, *supra*. On the other hand, the Sixth and Eighth Circuits have held to the contrary. See *Berry* v. *United States*, *supra*; *United States* v. *Donoho*, *supra*.

Other decisions cited by the taxpayer in relation to partnerships are explainable as follows: *Bell* v. *Commissioner*, 219 F. 2d 442 (C.A. 5th), did not involve the sale of a partnership interest. *Trousdale* v. *Commissioner*, 219 F. 2d 563 (C.A. 9th), and *Haggard* v. *Wood*, 298 F. 2d 24 (C.A. 9th), are cases where it was held that, considering the substance of the transaction, there was no sale of a partnership interest. In *Doyle* v. *Commissioner*, 102 F. 2d 86 (C.A. 4th), which involved the transfer by one partner to another, on the dissolution of the partnership, of a claim to fees for professional services, it was held that the amount received for the claim was taxable as ordinary income rather than as capital gain.

involve the sale of a partnership interest or interests as such. And even if the transaction were so treated, the fact would remain that the partners held back from the transfer an interest in property which is productive of ordinary income (subject to depletion) rather than capital gain.

3. Contrary to the taxpayer's contention (Pet. 16–28), the decision below is not in conflict with the court of appeals decisions in *Gowans* v. *Commissioner*, 246 F. 2d 448 (C.A. 9); *Barker* v. *Commissioner*, 250 F. 2d 195 (C.A. 2); or *Linehan* v. *Commissioner*, 297 F. 2d 276 (C.A. 1). In each of those cases, the court found that the particular transaction in question was a sale of sand and gravel "in place," and that the taxpayer-vendor had not retained an "economic interest" in the extracted material. The decisions of the Second and Ninth Circuits hinge upon the terms of their respective contracts, which the courts construed as imposing an absolute obligation upon the purchaser either to take a fixed quantity of material, or to pay a fixed price irrespective of the quantity of material in fact excavated. Thus, in *Barker, supra,* in addition to a $10,000 advance deposit, the contractor was required to pay no less than $3,000 quarterly "regardless of the amount of material actually taken." Similarly, in *Gowans, supra,* the court held that the owner of the land retained no economic interest in the "black sand" to be removed since the agreement provided for the removal of all the sand at a given unit price. Another factor

stressed by the court in *Gowans* was that the principal, if not controlling, purpose of the contract was to prepare the property for development as a real estate subdivision, not, as in the present case, to arrange for the economic exploitation of the sand and gravel deposits.

The Fifth Circuit's own prior decision in *Crowell Land & Min. Corp.* v. *Commissioner*, 242 F. 2d 864, is substantially similar to *Barker* and *Gowans*. There the contract provided that taxpayer *"as vendor * * * sold and conveyed * * * with full warranty of title, all sand and gravel underlying certain described property"* at a fixed price per cubic yard (emphasis in original). Since the vendee was not required to pay for material not taken, and since all sand and gravel not removed at the end of five years was to revert to the taxpayer, the transaction was not, strictly, the sale of a fixed quantity of material. However, the Fifth Circuit construed it as such, pointing out that all the material had in fact been removed by the vendee and dismissing the provision for reverter as merely the equivalent of a vendor's lien to secure the payments due the taxpayer. Moreover, in according the transaction capital gains treatment, the court noted that the contract contained no provision or suggestion for the retention and payment of a royalty as in oil and gas leases, and that the parties' intent to make a bona fide sale was expressed in terms free from ambiguity throughout the instrument. Here, by contrast, the instrument unambiguously provided for the retention of a "limited overriding royalty or production payment."

Petitioner chiefly relies for a showing of conflict upon the First Circuit's decision in the *Linehan* case, *supra*. There the purchaser acquired an exclusive "right to remove" sand and gravel from the taxpayer's land at a fixed price per cubic foot, there being no obligation to take or pay for a fixed amount. The court of appeals, though acknowledging the validity of the "economic interest" test, thought that the taxpayer had not retained such an interest because "in every instance he sold sand and gravel for fixed prices per cubic yard without reference to the prices received or the profits, if any, made by the exploiters."

This language—insofar as it focuses upon the "profits" and "prices" of the exploiters rather than their sales and proceeds—states the "economic interest" test more narrowly than the decisions of this Court warrant or the facts in *Linehan* required. The taxpayer there had no interest of any kind in the economic exploitation of the materials, if any, after they were severed from his property. Indeed, as the court's opinion indicates, his sole purpose in undertaking the transaction was to lower the elevation of his land and thereby render it suitable for industrial use. In contrast, the taxpayer here retained a continuing interest in the exploitation venture, for he was to be compensated only for materials "produced, saved and sold" by the exploiter and could look only to the proceeds of such sales for his limited royalty. Unlike his counterpart in *Linehan*, taxpayer here bore the risk that the materials, once extracted, might not find a market or might be wasted,

damaged, or destroyed between the point of severance and the point of sale. We submit, therefore, that despite the broad language used by the First Circuit in the sentence quoted above, the transaction in *Linehan* is readily distinguishable from the one involved here.

CONCLUSION

For the above reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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DECEMBER 1962.

U.S. GOVERNMENT PRINTING OFFICE: 1962